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22 May 2002

Mr Bill Niak
Investigator
Business Competition Branch
Commerce Commission
PO Box 2351
WELLINGTON

Dear Mr Niak

**COMMERCE ACT 1986: SUBMISSION ON APPLICATION FOR AUTHORISATION OF
PROPOSED ARRANGEMENT – ELECTRICITY GOVERNANCE BOARD LIMITED (EGBL)**

Please find attached a submission from TrustPower regarding the application by the Electricity Governance Board Limited for an authorisation of a proposed arrangement to combine the existing electricity market arrangements.

TrustPower requests the option to appear before the Commission at the conference planned for June 2002.

Yours faithfully

Peter Calderwood
STRATEGIC BUSINESS DEVELOPMENT MANAGER

**Submission to Commerce Commission
By TrustPower Limited
22 May 2002**

Introduction

This submission relates to the application by Electricity Governance Board Limited in respect of a restricted trade practice of the kind described in section 58 of the Commerce Act 1986.

TrustPower Limited ("TrustPower"), who is a retailer and generator of electricity, based in Tauranga, makes this submission.

This submission is structured in answer to the specific questions raised in the draft determination. The major issues considered to be of most importance are given in the following summary section.

Summary of Submission

The key concerns TrustPower has with the proposed Rulebook have not changed from TrustPower's initial submission. These are as follows:

- TrustPower submits that the Commission decline the application in its present form. However, we believe that with some modifications of the rulebook the arrangement should be approved.
- TrustPower does not support the assumption of Government regulation as the counterfactual for the arrangement and believes the appropriate counterfactuals are the existing arrangements.
- The new arrangement effectively precludes any competition in the use of alternative trading arrangements.
- The voting arrangements in many sections of the proposed rulebook provide effective control to sectors of the electricity industry, with the proposed Electricity Governance Board ("EGB") having almost no authority to effectively govern the new arrangements.

Details of the changes that need to be made to address the key issues are provided in the answers to the specific questions.

Answers to Specific Questions

1. *Has the Commission appropriately defined and incorporated the ancillary provisions in its assessment of the proposed arrangements?*

TrustPower agrees that the commission has appropriately defined and incorporated the ancillary provisions in its assessment.

2. *Are the markets defined by the Commission the appropriate markets for the assessment of the application?*

TrustPower has some reservations about the issue of national versus regional markets. When transmission constraints bind the national market parts of the country effectively become

regional markets. When this occurs there is often a single dominant supplier in the constrained area. This allows for the dominant supplier to set the wholesale electricity spot price at any level during the constrained periods.

3. *Does the wholesale pricing mechanism in the proposed arrangements breach s 30?*

The issue of whether the wholesale pricing mechanism breaches s 30 is a technical legal issue and TrustPower does not have any expert comment to make. However from a logical point of view it seems that since the wholesale pricing mechanism is compulsory and sets the price of electricity it must be a breach of s 30.

4. *Does the transmission pricing methodology in the proposed arrangements breach s 30?*

TrustPower agrees with the view of the Commission that the transmission pricing methodology, if working correctly in accordance with the GPS¹, would result in the transmission pricing methodology being in breach of s 30. If the EGB does not have sufficient powers to ensure a pricing methodology that meets the principles and objective then the process envisaged by the GPS is not working. If it does have the powers then there must be an implied fixing of prices because of this process.

5. *Do the cost allocation provisions in the proposed arrangements fall within the ambit of s 30?*

TrustPower agrees with the conclusion of the Commission that cost allocations for common quality is likely to impact on final prices and is covered by s 30. We also agree that the method of cost allocation, for the pricing manager and reconciliation manager, also fall with the ambit of s 30. In general, the costs allocated by these service providers are based on a variable \$/MWh and thus directly affect the marginal cost to those offering generation into the wholesale market.

6. *Has the Commission correctly applied the provisions of s 30 to the proposed pricing arrangements?*

TrustPower agrees with the approach taken by the Commission in applying the provisions of s 30.

7. *In the absence of the proposed arrangements, would the most likely scenario be likely to include a Crown EGB established under the EAA, with the Guiding Principles contained in the GPS and with operational rules similar to those in the proposed arrangements?*

In our original submission we argued that the appropriate counterfactual were the existing arrangements, being NZEM, MARIA and MACQS. In the draft determination the Commission has suggested that the proposed rulebook is very similar to the existing rules and then has concluded that the most likely counterfactual is a Crown EGB with operational rules similar to the proposed arrangements.

TrustPower's view is that if a Crown EGB is established it is more likely to adopt the existing rulebooks in the first instance, rather than the proposed rulebook, because this is a presently working model that can be adopted simply and then built upon. Therefore, even if it is accepted that a Crown EGB is the appropriate counterfactual, it should be based on a Crown EGB that governs the existing arrangements.

8. *Would a change to the proposed Guiding Principles so that they were more closely aligned with the principles and objectives in the GPS be likely to enhance competition or otherwise increase consumer welfare?*

It is difficult to determine whether the differences between the proposed Guiding Principles and the principles and objectives in the GPS either enhance or reduce competition. A simple solution to the problem, if one exists, would be to include the Government's overall objective

¹ Government Policy Statement: Further Development of New Zealand's Electricity Industry issued by the Minister of Energy – February 2002

into the rules of the proposed arrangement. The remainder of the GPS is based on defining outcomes, not guiding principles.

9. *Would the proposed voting arrangements be likely to lessen the likelihood of the implementation of desirable pro-competitive rule changes?*

TrustPower stated in its original submission to the Commission that it believed the dominance of the large generator retailers in the voting entitlements, in particular for Part G of the proposed arrangement, could lead to pro-competitive rule changes being voted down. This view has not changed.

The draft decision notes that the only means of controlling the commercial incentive by market participants to delay or prevent pro-competitive changes is by Government pressure and perhaps intervention. This is a very blunt instrument to use in an arrangement that is supposed to deliver energy in “an efficient, fair, reliable and environmentally sustainable manner to all classes of consumer”².

TrustPower believes that the EGB should have sufficient executive powers and a duty to review votes on rule changes and any recommendations by working parties to abandon rule changes to ensure these are not desirable pro-competitive changes. If the changes are considered to be pro-competitive by the EGB it should have the duty to put the rule change to the vote of the wider membership of the proposed rulebook³.

In addition the EGB should have similar powers where a rule change proposal voted on and passed has the effect of a material value shift between stakeholders or stakeholder groups.

10. *Under what circumstances would affected parties be likely to have sufficient commonality of interest to vote collectively against recommended pro-competitive rule changes?*

Given that in Part G of the rules in particular, the large generator/retailers long on generation have control over the voting entitlements, it is not hard to conclude that they will have similar incentives to protect the interests of large generators at the expense of competitive retailers and end use customers.

11. *What examples are there in existing NZEM, MACQS and MARIA governance arrangements of pro-competitive rule changes being voted down?*

TrustPower is not aware of any pro-competitive rule changes being voted down, but this is in reality an academic question, because market participants are unlikely to put up rule changes that they know are unlikely to be successful given the voting powers of the individual generators.

As an example of this, TrustPower has been attempting to have rule changes relating to loss and constraint rental allocations through working groups and then to a rule change vote since 1999. These changes would have had a major impact in improving competition. To date, TrustPower has not been successful in having any changes adopted and the decision process has now been taken over by the Government.

12. *What examples are there under NZEM, MACQS and MARIA of pro-competitive rule changes being implemented?*

The only pro-competitive rule changes that have been adopted by the existing arrangements have been those related to customer switching and non-half hour meter reconciliation under the MARIA rules. These were put in place as the result of Government pressure in 1998.

² Excerpt from the GPS

³ This wider membership could be based on the voting entitlements for members of the EGB (votes allocated to generator/retailers (1/3), distributors/grid owners (1/3) and approved consumer groups (1/3))

It could be argued that a rule change through NZEM last year, which changed the prudential requirements for the market to allow settlement of hedges through the market, has the effect of increasing competition. In reality this did not result in a pro-competitive result because most of the large generators will not participate.

13. *What rules in the proposed Rulebook have the potential to be changed in a way that would enhance competition?*

The trading rules in particular in the proposed rulebook have been based on the existing NZEM, but made compulsory for all participants. One of the key reasons for the trading rules is to ensure that optimum dispatch of generation occurs to achieve the lowest overall cost. However, dispatch is of little relevance to small must run generators, who often trade bi laterally using the MARIA rules in the existing arrangements. The new rulebook has the potential to provide a barrier to entry for new distributed and renewable generation because of the cost of compliance with the rules designed for large generators.

There is potential for rule changes to cater for new technology low cost distributed generation to compete against large existing generators.

14. *From the consumer perspective, do the proposed voting arrangements give rise to any concerns, and if so in what areas?*

The proposed arrangements are almost silent on issues relating to consumers, concentrating on issues relating to the rights and obligations of generators and energy traders in particular.

TrustPower considers this to be a major failing of this rulebook in that it is almost completely supply side dominated but is being promoted as an Industry governance regime.

15. *What services would be likely to be provided on a competitive basis under a Crown EGB? How does this situation compare with the proposed arrangements?*

TrustPower agrees with the Commission's view that the compulsory nature of the proposed arrangement is likely to preclude other arrangements for administration, pricing and clearing. These are available at present through the use of the MARIA arrangements for reconciliation of quantities and potentially through other alternative arrangements.

16. *Would the proposed provisions relating to the pricing of services to non-members result in a lessening of competition compared with the situation in the Commission's counterfactual?*

TrustPower agrees with the Commission's view that as membership of the proposed Rulebook is effectively compulsory there is little chance of services being charged to non-members.

17. *Would the provisions of Part C of the Rulebook relating to common quality lessen competition compared with the counterfactual?*

TrustPower agrees that in any likely counterfactual the provisions relating to common quality in Part C are likely to be very similar to those in the proposed arrangement.

18. *Would the provisions of Part D of the Rulebook relating to metering arrangements lessen competition compared with the counterfactual?*

TrustPower agrees with the Commission's view that metering arrangements are likely to be materially the same in any counterfactual.

19. *Would the provisions of Part E of the Rulebook relating to registry information and customer switching lessen competition compared with the counterfactual?*

TrustPower agrees with the Commission's conclusions that the provisions in Part E of the proposed Rulebook will not lessen competition.

20. *What are the likely differences in ability between an Industry EGB and a Crown EGB to assess pricing methodologies, and what would be the benefits and detriments associated with any differences?*

There is a major difference between an Industry EGB and a Crown EGB when it comes to assessing the pricing methodologies of the transmission provider. Transpower is the sole transmission provider at present, and is likely to remain so for the foreseeable future. Transpower is also very likely to remain a Government owned entity, under closer direction by Government than many other SOEs. It is likely that Transpower will have a greater influence on a Crown EGB, than it would on an Industry EGB, given the ability of Government to direct a Crown EGB.

TrustPower believes that an Industry EGB, with the appropriate controls, as there are in Part F of the proposed Rulebook, is the most independent and effective body to assess proposed transmission pricing.

21. *If there are any existing pricing inefficiencies relating to the HVDC link, would they be likely to be addressed as effectively by an Industry EGB as by a Crown EGB?*

As stated above, an Industry EGB is more likely to be more independent in assessing any pricing inefficiencies than a Crown EGB, given the more direct influence a Government can have on a Crown EGB.

22. *The Commission invites comment on its assessment of the arrangements for pricing and investment decisions under the counterfactual.*

TrustPower's view is that a Crown EGB would have more power than an Industry EGB to impose transmission-pricing methodologies onto purchasers of transmission services. This has the potential to allow capture by the transmission provider of the process, without appropriate interaction with the customers and other stakeholders.

23. *The Commission invites comment on its assessment of the impacts on transmission investment in the proposed arrangements relative to the counterfactual.*

As stated by Murray and Hansen on behalf of the applicant, there will be a tendency for a Crown EGB to be the 'investor of last resort' and may over invest in transmission assets compared to an Industry EGB with a 75% hurdle on new investment.

The concerns relating to voting powers could be solved by allowing rule changes to be reviewed by the EGB in a similar manner to that referred to in the answer to question 9.

24. *The Commission invites comment on its assessment that the transmission pricing methodology is likely to be similar under either governance arrangement.*

As stated above, TrustPower considers that Transpower is likely to have greater influence over a Crown EGB compared to an Industry EG, hence the outcome may not be the same in both cases.

25. *Would the provisions of Part G of the Rulebook relating to trading arrangements lessen competition compared with the counterfactual?*

The key issue that is of concern with Part G is the compulsory nature of the trading arrangements. TrustPower does not consider that any valid reason for the compulsory trading of all generation, given that bi-lateral trading is successfully operating in the existing market structures.

We believe that the compulsory nature of Part G does lessen competition compared to the counterfactual.

26. *Would the provisions of Part H of the Rulebook relating to clearing and settlement lessen competition compared with the counterfactual?*

TrustPower agrees with the conclusion of the Commission that the rules in Part H are similar to what would be expected in any counterfactual.

27. *Would the provisions of Part I of the Rulebook relating to implementation and transitional issues lessen competition compared with the counterfactual?*

TrustPower agrees with the Commission's view.

28. *Notwithstanding the Commission's usual approach of not counting transfers of wealth between one group and another either as a benefit or detriment, having regard to the principles of the GPS which emphasise the well-being of consumers, is there a case in this instance for recognising transfers from consumers to producers in this assessment of detriments? If so, what weight should be given to this factor when assessing detriments against benefits?*

Given that the majority of the proposed Rulebook deals with issues relating to the generation, transmission, distribution and retailing businesses, and how they inter-relate, there is little, if any, change in the respective wealth from consumers to producers. The consumer related issues in the GPS have not been dealt with in the proposed Rulebook and are being handled separately.

There is, however, potential for value shifts between the various producer groups as a result of the proposed Rulebook. In particular the compulsory nature of Part G could have the effect of disadvantaging new entry economic distributed generation.

29. *Is the Commission's assessment of the influence that the GPS would have on an Industry EGB relative to a Crown EGB correct?*

TrustPower agrees with the Commission's assessment.

30. *To the extent that influence differs, what would be the impact on benefits and detriments?*

An industry EGB, with only indirect direction from Government is likely to be a better overall outcome than a Crown EGB, which can be directed in detail from Government.

31. *Is the Commission's assessment of the rule and decision-making capabilities of the industry relative to the Minister and Crown EGB correct?*

TrustPower agrees with the Commission's conclusion that the industry would be more competent in assessing the merits of a proposed rule change than a Crown EGB.

32. *Are there other markets where the proposed arrangements are likely to have a material impact on public benefits and detriments?*

TrustPower does not believe the proposed arrangements will have a material impact on public benefits and detriments in other markets, compared to the counterfactual.

33. *Would the cost of capital be different in the proposed arrangements relative to the counterfactual?*

Regulatory risk is a real risk facing privately owned companies such as TrustPower. During the last ten 10 years successive Governments have interfered in the structure of the electricity business in New Zealand. Potential investors do react negatively to continued interference from Government. This is more likely to be the case under a Crown EGB.

Although it is difficult to quantify, it is demonstrated by the differing views between the Applicant and the Commission on the effect of the loss of public benefit, there will be a higher overall cost of capital with Crown EGB relative to an Industry EGB.

34. *Would regulatory risk affect only the cost of capital for private sector interests?*

Although the effect on Crown Owned Entities may be sheltered against a higher cost of capital in a Crown EGB arrangement, because of the common ownership, they should not be. To suggest that a SOE can operate with a lower cost of capital than a respective privately owned company causes a distortion in itself between competitors and may have the effect of reducing competition, and ultimately creating total Government ownership of the industry.

35. *What weight should the Commission give to the potential effects of a Crown EGB on productive and dynamic efficiency in the generation and service provider markets?*

Because of the uncertainties of exactly how much comparative benefit there would be from an Industry EGB compared to a Crown EGB it is hard to comment on the range of the NPV determined by the Commission. The main conclusion is that an Industry EGB would have a comparative advantage in decision-making.

36. *Would a Crown EGB have a comparative disadvantage in deciding on recommendations to rule changes?*

A Crown EGB would have a comparative disadvantage in deciding on recommendations to rule changes given the greater distance from the practical knowledge of the actual industry participants.

37. *If so, would it also have an impact on allocative efficiency in the wholesale electricity market?*

TrustPower agrees that a Crown EGB is likely to have a negative effect on allocative efficiency in the wholesale electricity market compared to an Industry EGB.

38. *Would there be higher lobbying costs in the counterfactual? Is the Commission's assessment of this potential cost of an appropriate order of magnitude?*

TrustPower strongly believes that there will be considerably higher lobbying costs under a Crown EGB relative to an Industry EGB, owing to the dual role of lobbying and influencing both the Crown EGB structure as well as the Government's advisors.

This is of particular concern to smaller companies such as TrustPower, who may be disadvantaged in not being able to provide as much resource into lobbying as larger players in the industry, especially those companies owned by the Government.

39. *Would industry input into a Crown EGB's investment decisions provide a restraint on the potential for over-investment and over-maintenance of the grid?*

Industry input into a Crown EGB's investment decisions would provide some restraint on over investment, however, a Crown EGB is still likely to take a more conservative view overall, given the political direction it will have. Over investment and over maintenance is the likely result, given the ability of the Crown EGB to recover costs through regulated pricing.

40. *Is the Commission's assessment of the likelihood of contestable services appropriate?*

TrustPower agrees with Commission's assessment.

41. *Are there examples from other industries of the magnitude of benefits available through making services contestable?*

TrustPower has no examples from other industries.

42. *Is the Commission's assessment that under a Crown EGB if services were made contestable, it would also allow competitive bypass of service providers correct? If so, would the efficiency gains from that additional competition have a material impact on net benefits?*

We agree with the assessment that a competitive bypass of service providers is unlikely to provide direct efficiency gains. However, it is important that service providers have competitive pressure in the level of service provided, as this could have a substantial effect on the overall efficiency of the market.

43. *What scope is there for the proposed arrangements to change over time to remove or lower entry barriers or improve efficiency in the relevant markets?*

As stated earlier, TrustPower believes the voting structure has a potential to delay the introduction of new rules, which remove or lower entry barriers, particularly by small generators. We have proposed that the Industry EGB should have greater executive powers to mitigate this dominance in the voting structure.

44. *What are the incentives on distributors to vote on reduction or elimination of grid constraints?*

Although the application of the proposed Rulebook has yet to be tested, distributors may not be the parties that will end up voting on such issues as the elimination of grid constraints that do not affect security. It is more likely that generators, retailers or end consumers will agree that a constraint requires to be eliminated. They will then vote and meet the cost directly on an agreed pricing methodology.

45. *Are distributors likely to have different attitudes to elimination of transmission constraints that have security implications and transmission constraints that lead to higher energy prices?*

Clearly, the distributors will have a different view to transmission constraints that have security implications compared with energy price implications.

As stated above it may not be the distributors who meet the costs of grid reinforcement to relieve constraints.

46. *Quantification of the potential range of detriments indicates that the principle detriments arise from a reduction in competition in the generation markets, and the corresponding weakening in incentives for generators to be efficient. Is the Commission's preliminary assessment that under-investment in the grid would provide strong scope for generators to exercise market power correct?*

TrustPower agrees that under-investment in the Grid would provide strong scope for generators to exercise market power in constrained regions.

47. *The Commission's preliminary assessment is that the proposed arrangements are likely to allow generators to increase electricity prices above competitive levels. This would result from both the potential for strike-down of pro-competitive rules and under-investment in transmission. Apart from deadweight losses, are there other public detriments that would arise from an increase in electricity prices?*

The main issue that affects the detriments listed above are related to the voting structure within the rule making process. If this were modified, as suggested earlier in our submission, to mitigate the dominance effect in the rule making process the ability to increase prices would be limited.

48. *The Commission seeks comment on whether the issues that have been considered in this Draft Determination provide a reasonable summary of the issues of which it should be aware before making a final decision on this Application. The views of interested parties are sought on any additional issues that might be of relevance when considering the benefits or detriments to the public that might result from the proposed arrangements, should they proceed.*

TrustPower believes the Commission has raised all of the appropriate issues in its draft determination.

49. *If the Commission chose to authorise the proposed arrangements, what condition(s) on the authorisation would address concerns about the potential for pro-competitive rule changes not being implemented and any negative downstream effects.*

By giving the Industry EGB more executive powers as suggested in response to earlier questions, there would be considerably more scope for the introduction of pro-competitive rule changes.

50. *What would be the benefits and detriments arising from such a condition(s)? Would the imposition of such a condition(s) be consistent with the Act?*

The benefits of giving the EGB more scope to refer rule changes to the wider stakeholder group is to reduce the dominant position given to a few industry participants by the rules as they now stand.

51. *Are there any other matters which the Commission could appropriately address with conditions to an authorisation?*

TrustPower believes the trading arrangements in Part G of the rules should not be mandatory and the rules be amended to more closely mirror the existing alternative arrangements using NZEM or MARIA.

52. *Is it appropriate to use a ten year time horizon for the purpose of calculating benefits and detriments?*

The likelihood of a further change to the rules governing the electricity market within a ten-year period is high given changes within the last ten years. On that basis we agree that a ten-year horizon is appropriate.

53. *Are the Commission's assumptions on the magnitude of efficiency gains arising from the comparative advantage of industry arrangements relative to the counterfactual appropriate?*

Although the assumptions are hard to quantify, TrustPower generally concurs with the relativities between the various options.

54. *Are the Commission's estimates of the higher transactions costs in the counterfactual of an appropriate order of magnitude?*

TrustPower agrees with the Commission's conclusions.

55. *Are the Commission's assumptions on the potential range of efficiency losses in the counterfactual of an appropriate order of magnitude?*

TrustPower agrees with the Commission's conclusions.

56. *The Commission invites comment on its assessment of the magnitude of efficiency losses in the counterfactual relative to the proposed arrangements.*

TrustPower agrees, in principle, with the assessment by the Commission. In particular, it is important to consider the system operator function; this is by far the largest cost of the arrangement.

57. *The Commission invites comment on its assessment of the likelihood that service providers and system operator roles would be made contestable under the proposed arrangements, relative to the counterfactual.*

The system operator function is the most sensitive to variance between an Industry EGB and a Crown EGB. We agree with the conclusion that there is a far greater probability of the system operator role being made contestable under an Industry EGB.

58. *The Commission invites comment on its assessment of the potential for price increases, relative to the counterfactual.*

TrustPower agrees with the Commission's assessment of the ability of major vertically integrated generators to strike down pro-competitive rules with a possible significant effect on electricity prices.

59. *Are the assumptions on long-run supply and demand elasticities appropriate?*

TrustPower has no reason to dispute the assumptions on long-run and demand elasticities.

60. *The overall detriment resulting from delayed investment is calculated to be \$1.5 million NPV, reflecting the low likelihood of a dry winter. Are there any assumptions, which, if varied appropriately, would lead to a significant difference in the result?*

Although the calculated result is consistent with the input variables, the impact of the risk portfolios of retailers and end use customers exposed to the high dry winter prices has not been considered in the simple NPV analysis.

Delayed investment resulting in high prices which cannot be hedged against is likely to have a greater impact on businesses that are external to the electricity industry with overall economic consequences far greater than that modelled.

61. *Is the Commission's assessment of the magnitude of potential efficiency losses arising from a reduction in competitive pressure appropriate?*

TrustPower has no reason to dispute the assumptions made by the Commission.

62. *Is the Commission's assessment of the likelihood of under-investment in transmission under the proposed arrangements, relative to the counterfactual, appropriate?*

We believe the Commission has taken an overly pessimistic view of the under-investment in transmission. TrustPower believes the processes in Part F of the rules will allow innovative solutions that will increase transmission capacity where appropriate.

63. *Are there any assumptions which, if varied appropriately, would lead to a significant difference in the calculation of detriments arising from transmission outages?*

Our comments in response to question 62 above apply to the effect of transmission outages. Part F of the rules will allow for innovative solutions that are more likely to arrive at the most economically efficient solution under an Industry EGB, rather than a Crown EGB, more likely to over invest.

64. *Are there any assumptions which, if varied appropriately, would lead to a significant difference in the calculation of detriments that could arise from inefficient location of new investment?*

Distributed generation needs to be considered as an alternative to new transmission investment. The extra cost of distributed generation needs to be optimised against the cost of new investment in transmission. An Industry EGB is more likely to follow the Part F process to determine the most efficient outcome overall than a Crown EGB who will tend to be more conservative and consider a transmission investment ahead of distributed generation to provide capacity.